

## 2. Tax Matters

*This section provides a discussion and overview of the tax consequences of transfers, investments, and withdrawals from your Guaranteed Education Tuition account. It does not address other state or local taxes, including taxes imposed by a state other than Washington. If you live outside the U. S., you should consult a qualified tax advisor regarding your individual situation.*

### Caveats With Respect to Tax Discussion

This summary is not exhaustive, and you should not construe it as providing advice on your particular situation. In addition, there can be no assurance that the Internal Revenue Service ("IRS") will accept the conclusions in this Program Detail/Master Agreement, or, if challenged by the Service, that these conclusions would be sustained in court. The applicable tax rules are complex, some of the rules are uncertain, and their application to any particular person may vary according to facts and circumstances specific to that person. This section is not intended to constitute, nor does it constitute, legal or tax advice. You should consult your legal or tax advisor about the impact of these rules on your individual situation.

### Changing Tax Laws and Regulations

The summary is based on the relevant provisions of the Internal Revenue Code of 1986, as amended (the "Code"), the Proposed Regulations, relevant legislative history, and official interpretations of applicable federal and Washington law as of the date of this Program Detail/Master Agreement documents. The President of the United States on June 7, 2001, signed into law the Economic Growth and Tax Relief Act of 2001, (the "2001 Tax Act"), which significantly changed the federal tax treatment of the Program and the accounts therein, including the treatment of withdrawals from the accounts. These provisions of the 2001 Tax Act, which are generally described below, are generally effective for taxable years beginning after December 31, 2001, through December 31, 2010, unless otherwise extended by future legislation. Additional changes to federal or state tax laws could occur in the future that could have a significant impact on the Program and your investment or result in termination of the Program.

### Effective Period of 2001 Tax Act

By its terms the 2001 Tax Act will automatically expire on December 31, 2010, restoring the law to its form prior to the enactment of the 2001 Tax Act. Accordingly, unless additional legislation is enacted prior to that date to extend the effective period of the 2001 Tax Act, the favorable changes made in the 2001 Tax Act to the federal tax treatment of qualified tuition programs will expire on December 31, 2010. *Account Owners and Student Beneficiaries should consult their tax advisors about the potential likelihood that the effective period of these favorable changes will be extended and the consequences if it is not.* In general terms, unless the effective period is extended or Section 529 of the code is modified through additional legislation, the following tax rules, among others, relating to 529 programs such as the Program would expire on December 31, 2010:

- The exclusion from the Student Beneficiary's gross income of the earnings portion of withdrawals used to pay for such Student Beneficiary's Qualified Higher Education Expenses.

- The additional 10% federal penalty tax on the earnings portion of certain taxable withdrawals (in lieu of this tax, the 529 Plan would be required to assess a "more than de minimis" penalty on such amounts).
- The ability under certain circumstances to make a qualified, tax-free rollover distribution for the benefit of the same Student Beneficiary.
- The ability under certain circumstances to treat as a Qualified Withdrawal a transfer from one qualified tuition plan account to an account in another qualified tuition plan for the same Student Beneficiary.
- Inclusion of the first cousins within the definition of "member of the family" of a Student Beneficiary.
- Certain favorable gift, estate, and generation-skipping transfer tax provisions.

### Federal Income Tax Treatment of Investments and Distributions

The Program is designed to constitute a "qualified tuition program" under Section 529 of the Code. Generally, earnings in the Program will not be includable in computing the federal taxable income of the Account Owner or the Student Beneficiary while held in the account. As described in greater detail below, whether the earnings are taxed upon withdrawal depends upon how the withdrawal is used.

### Qualified Higher Education Expenses

Section 529 of the Code defines "Qualified Higher Education Expenses" as tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a Student Beneficiary at an Institution of Higher Education (see the Program Master Agreement, Section I, "**Definitions**" for further details). The term also includes certain amounts for room and board for Beneficiaries attending school at least half-time in a degree or certificate program. The amount of a Student Beneficiary's room and board expenses that can be counted as a Qualified Higher Education Expense generally may not exceed the amount applicable to the Student Beneficiary included in the "cost of attendance" (as defined under the federal law as of June 7, 2001) at the Institution of Higher Education. In the case of a Student Beneficiary living in housing owned or operated by an Institution of Higher Education, however, the amount of room and board expenses that can be counted as Qualified Higher Education Expenses is the greater of (a) the amount described in preceding sentence, or (b) the actual amount charged the Student Beneficiary by the Institution of Higher Education for room and board for such period. Qualified Higher Education Expenses also include certain additional enrollment and attendance costs of special needs beneficiaries.

## Qualified Withdrawals

Withdrawals used to pay for Qualified Higher Education Expenses (“Qualified Withdrawals”) will be excludable from the Student Beneficiary’s and the Account Owner’s federal taxable income. Account Owners should retain documentation such as invoices and receipts adequate to substantiate to the IRS (the “Service”) the qualifying use of such withdrawals. There are two components to such a Qualified Withdrawal: (1) return of principal and (2) distribution of earnings. Although neither component is taxable for a Qualified Withdrawal, separately accounting for such components is necessary in order to determine how much of the remaining investment in the accounts consists of earnings and how much consists of principal invested. The earnings portion of a particular withdrawal will generally be determined as of the withdrawal date, rather than in the aggregate for all distributions as of the end of the year. Pending guidance from the Service, it is unclear whether a withdrawal used to pay for Qualified Higher Education Expenses incurred or paid prior to the establishment of the accounts will be treated as a Qualified Withdrawal. Pending guidance from the Service, it is also unclear whether a withdrawal taken after December 31 of the year in which the Qualified Higher Education Expenses were incurred and paid will be treated as a Qualified Withdrawal. Please consult with a qualified tax advisor.

Although the Service has not yet provided guidance on this issue, if amounts from a Qualified Withdrawal that were used to pay Qualified Higher Education Expenses are subsequently refunded in whole or in part to the Account Owner or the Student Beneficiary by the educational institution or other payee, the Account Owner may be required to include the earnings portion of such refund in taxable income for federal income tax purposes and pay the additional 10% penalty tax on such earnings. Such inclusion may not be required if the refunded amount is either reinvested in the accounts or used to pay other Qualified Higher Education Expenses of the Student Beneficiary.

## Nonqualified Withdrawals

Under Section 529, the earnings portion of withdrawals from an account other than Qualified Withdrawals (i.e., Nonqualified Withdrawals) is includable in computing the income of the Account Owner (or possibly of the Student Beneficiary if the Nonqualified Withdrawal is paid to the Student Beneficiary) for federal income tax purposes in the year in which the withdrawals are made, except for certain nontaxable transfers to an account or another Section 529 Program as explained in more detail in the Master Agreement under **“Rollover Contributions”** in Section III. The computation of the portion of a Nonqualified Withdrawal that is includable in taxable income is again made under a pro-rata allocation between a nontaxable return of principal and a taxable distribution of earnings.

The earnings portion of any Nonqualified Withdrawal generally will be subject to an additional 10% penalty tax, in addition to applicable income tax. The additional 10% penalty tax will not apply, however, to (a) certain withdrawals made on account of the death or disability of the Student Beneficiary and certain withdrawals made on account of a scholarship received by the Student Beneficiary to the extent such withdrawals do not exceed the amount of the scholarship (see **Section V. Refunds**), and (b) nontaxable transfers to another account or another 529 program as explained in more detail under **“Rollover Contributions”** in Section III of the

Master Agreement. Nonqualified Withdrawals that qualify for an exception to the additional 10% penalty tax, other than nontaxable transfers to an account or other 529 program, are still subject to applicable federal income tax. A “financial hardship” would not entitle you to any special treatment under federal tax laws or to any exemption from the additional 10% federal penalty tax. As noted above, you would be entitled to an exception to the additional 10% penalty tax (but not to the imposition of applicable income tax) if you made a Nonqualified Withdrawal in the case of a Student Beneficiary who died or became disabled.

## Aggregation of Accounts

All accounts in the GET Program having the same Student Beneficiary must be treated as a single account for purposes of calculating the earnings portion of each distribution from any such account. Thus, if more than one account is created by an Account Owner for a Student Beneficiary, and a Nonqualified Withdrawal is made from one or more of such accounts, the amount includable in income must be calculated based upon the ratio of total earnings in all such accounts to the total amount in such accounts. Thus, the amount withdrawn from an account may carry with it a greater or lesser amount of income than the earnings in that account alone would justify, depending on the earnings in the other relevant account or accounts.

## Transfers between Accounts of Different Designated Beneficiaries or Different 529 Programs

An Account Owner may change the designated Student Beneficiary of an account or may transfer (i.e., “rollover”) an amount from an account to an account for a different Student Beneficiary, or to or from an account for a different Student Beneficiary under another 529 Plan (provided such rollover occurs within 60 days of the withdrawal), without the amount distributed having to be included at that time in the federal taxable income of the Account Owner or any Student Beneficiary (and without being treated as a Nonqualified Withdrawal).

In order to qualify for this tax-free treatment, a new designated Student Beneficiary must be a “member of the family” of the current Student Beneficiary. **See Section III, Rollover Contributions.**

If the new Student Beneficiary is a member of a younger generation than that of the current Student Beneficiary, a federal gift tax may apply and if the new Student Beneficiary is two or more generations younger than the current Student Beneficiary, a federal generation-skipping transfer tax may apply. This tax applies in the year in which the money is withdrawn from an account or in which the designated Student Beneficiary is changed.

Tax-free treatment is also available for a rollover from an account in another 529 Plan for the benefit of the same Student Beneficiary, provided that it has been at least 12 months since the most recent such rollover for that Student Beneficiary.

Rollover amounts from another 529 Plan generally retain their character as earnings and invested principal. Until the program receiving the rollover receives documentation from the distributing program showing the earnings portion, however, the receiving program will treat the entire amount of the rollover as earnings.

## Federal Gift and Estate Taxes

Investments in accounts are considered completed gifts for federal estate and gift tax purposes. Generally, if the Account Owner dies while there is still money in his or her accounts, the value of the accounts would not be included in the Account Owner's estate (except in the situation described below relating to the gift tax election for investments exceeding \$11,000 in any one year). However, amounts distributed on account of the death of a Student Beneficiary are included in the gross estate of that Student Beneficiary for federal estate tax purposes.

Account investments are potentially subject to federal gift tax payable by the contributing Account Owner. Generally, if an Account Owner's investments in an account or accounts for a Student Beneficiary, together with all other gifts by the Account Owner to the Student Beneficiary, are less than \$11,000 per year (\$22,000 per married couple), no federal gift tax will be imposed on the Account Owner for gifts to the Student Beneficiary during that year.

If an Account Owner's investment in an account for a Student Beneficiary in a single year is greater than \$11,000 (\$22,000 per married couple), the Account Owner may elect for federal gift tax purposes to treat the investments up to \$55,000 (\$110,000 per married couple) as having been made proportionately over a five-year period. However, if the Account Owner dies before the five-year period has elapsed, the portion of the investment allocable to years remaining in the five-year period (except for earnings on such investment) would be includable in the Account Owner's estate for federal estate tax purposes.

A withdrawal from an account, a permissible change of the designated Student Beneficiary, or a permissible transfer to an account for another Student Beneficiary will not be subject to federal gift or transfer tax, except that such a change or transfer will potentially be subject to gift tax if the new Student Beneficiary is of a younger generation than the Student Beneficiary being replaced and will potentially be subject to the generation-skipping transfer tax if the new Student Beneficiary is two or more generations younger than the Student Beneficiary being replaced.

Because investments in an account are treated as completed gifts for federal transfer tax purposes, you may also need to be concerned about the generation-skipping transfer tax for yourself or the Student Beneficiary. This tax may apply to investments in excess of the amount that may be elected to be proportionately spread over the five-year period discussed above if the Student Beneficiary is deemed to be a member of a generation that is two or more generations younger than the generation of the Account Owner. In addition, as noted above, if a change is made in the designated Student Beneficiary such that the new Student Beneficiary is two or more generations younger than the former Student Beneficiary, the generation-skipping transfer tax may also be triggered.

Generally, taxpayers are eligible for a limited generation-skipping transfer tax exemption that will be allocated to transfers that are subject to generation-skipping transfer tax. Accordingly, this tax may not apply to many Account Owners and Beneficiaries. However, where it applies, it is imposed at a flat rate.

Beginning in taxable years after December 31, 2001, substantial changes have been made to the estate, generation-skipping, and gift tax rules under the 2001 Tax Act. In general, the 2001 Tax Act

reduces tax rates, increases the exemption amounts, and repeals the estate and generation-skipping taxes as of 2010. Account Owners and Beneficiaries should consult a qualified tax advisor regarding the specific application of these new rules to their particular circumstances.

*Estate, gift, and generation-skipping tax issues arising in connection with 529 Plans can be quite complicated. You should consult with your tax advisor if you have any questions about these issues.*

## Coverdell Education Savings Accounts (ESAs)

ESAs permit deferral of federal income tax liability, and possible exclusion from gross income for earnings in such ESAs. If withdrawals are made from an account and an ESA in the same year for the same Student Beneficiary in excess of qualified higher education expenses, however, you will need to allocate qualified higher education expenses between the two programs.

You may make contributions to your accounts in the Program and to an ESA in the same year. You may also take a distribution of part or all of your ESA and invest it as a contribution to your accounts. Such a distribution is considered a qualifying ESA distribution that is not subject to federal income tax.

## Series EE and I Bonds

Interest on Series EE Savings Bonds issued January 1990 and later, as well as interest on all Series I Savings Bonds, may be completely or partially excluded from federal income tax if bond proceeds are used to pay certain higher education expenses at an Institution of Higher Education or are contributed to an account in the same calendar year the bonds are redeemed. For this purpose, qualifying expenses do not include the cost of books, supplies, or room and board. The amount of higher education expenses taken into account in calculating the interest excludable from income is reduced by scholarships, fellowships, and certain other forms of tuition assistance. Certain income limitations apply and the Student Beneficiary must have a specified relationship with the Account Owner. Provided appropriate documentation is furnished to the Program, the original purchase price of the bonds redeemed and contributed to an account will be added to the contribution portion of the accounts, with the interest added to earnings.

## Hope Scholarship and Lifetime Learning Credits

A taxpayer may not claim a Hope Scholarship Credit or Lifetime Learning Credit for amounts withdrawn tax free from an account and used for qualified educational expenses, but may be eligible for these credits for educational expenses paid from other sources during the year.

## Tax Deduction for Education Expenses

The 2001 Tax Act provides for a deduction for the payment of tuition and related expenses by taxpayers who fall within certain income limits. The deduction may not be claimed, however, for expenses that were paid from the earnings portion of a tax-free withdrawal from an account.